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The peculiar first semester of 2012

António S. Pinto Barbosa
Luís Catela Nunes

NOVA School of Business & Economics
Shaping powerful minds

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The peculiar first semester of 2012[1]

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António S. Pinto Barbosa **Luís Catela Nunes**

1. The international financial crisis that hit the world economy in 2007 and the reaction that followed through the implementation of austerity programs in several economies gave a special opportunity to evaluate the relative merits of two competing arguments. On the one hand, is the argument that such austerity essentially produced a contraction in the economies in which it was applied, causing a reduction in output and an increase in unemployment. This corresponds to the *Keynesian* view of austerity, with the implicit suggestion that its detrimental effects would tend to aggravate rather than attenuate the impact of the initial shock[2]. In contrast, there is the argument stressing the potential improvement in the level of confidence of economic agents, in particular investors, that might result from the application of smart austerity packages. This corresponds to the *German* view of austerity[3]. From this standpoint, an appropriately designed austerity program may induce the economic agents to believe that the economy will soon resume a healthy path via the control of its main macro desiquilibria. This positive impact on the expectations of economic agents will tend to stimulate aggregate spending and produce a beneficial expansionary effect in the economy.

2. Portugal could not easily escape this controversy, as it was subjected in 2011 to one of the most stringent austerity packages implemented during the crisis, a package known as the *troika* program. As one would perhaps expect, the interpretation of the effects of this program gave space to a vivid

[1]Communication presented at the Academia de Ciências de Lisboa on 9/2/2017. We thank Paulo Pinho for comments an earlier version.

[2]See, for instance, "Europe's Keynesian Problem", Krugman, P. *The Conscience of a Liberal*, 25/5/2013.

[3]Several authors discussed this argument, for example, Giavazzi, F e M. Pagano (1990), "Can Severe Fiscal Contractions Be Expansionary? Tales of Two Small European Countries", NBER Macroeconomics Annual 1990, Volume 5, pages 75-122 National Bureau of Economic Research, Inc., ou Alesina, A. e Ardagna, S. (2012) "The Design of Fiscal Adjustments", NBER WP 18423.

confrontation between those opposing views. Our purpose here, today, is to bring some brief thoughts on this subject. We start by acknowledging that the *Keynesian* view is so well documented in the data that show a significant contractionary effect in the Portuguese economy and a deterioration in the basic macro indicators, that there seems to be no question about the importance of this argument. As to the second view, which points to a positive effect of the package on expectations, an effect which might possibly coexist with the first view, available information is, however, scant and debatable. We thus thought it would be of interest to concentrate on this more controversial topic, asking the following two questions: first, has the implementation of the *troika* program been able to lift up to some extent the confidence of the economic agents, namely investors? Second, if so, has this effect on expectations been translated into some positive impulse, however limited and partial, to aggregate spending so that an even sharper fall in demand would have ocurred had it not existed? As we acknowledge that an answer to this important second question is clearly beyond our present research limitations, we concentrate on the first one, admitting that it would still be of some interest.

3. Has the implementation of the austerity program in Portugal been able to lift expectations and raise the confidence level of economic agents? An answer to this question requires a preliminary identification of an indicator that may, to some extent, signal modifications in the confidence levels of economic agents. The ten-year yield of Portuguese government bonds would seem appropriate for this purpose, as it is an indicator normally used for similar analysis. To be sure, this indicator reflects the influence of many other factors, namely the actual and expected evolution of reference rates set by the European Central Bank. But it reflects also, to some extent, as an important factor, the country risk premium, which represents, to a great extent, the assessment of the country's financial and economic health by investors in the international capital market.

4. How did the ten-year yield of Portugal sovereign debt react to the implementation of the *troika* program? Figure 1 depicts such evolution between January 2010 and January 2013. We also signal the formal beginning of the program in May 2011 with a vertical line.

During this whole period we note a clear increasing trend in the yield until January 30, when it reaches a maximum of 17.39 %. From that date on the rate trends downward with oscillations. Since this downward path occurs when the austerity program had been running for about eight months, the question emerges whether this might be a consequence of its implementation. In other words, a plausible conjecture may be that the successful way in which the program was being implemented might have boosted investor perceptions that things were starting to get under control and that the main macro desequilibria were being properly tackled.

5. One basic difficulty with this interpretation stems from the fact mentioned above that sovereign yields reflect multiple influences, some of them not necessarily related to national circumstances. In particular, the role of the European Central Bank in setting the reference rate in the eurozone is of

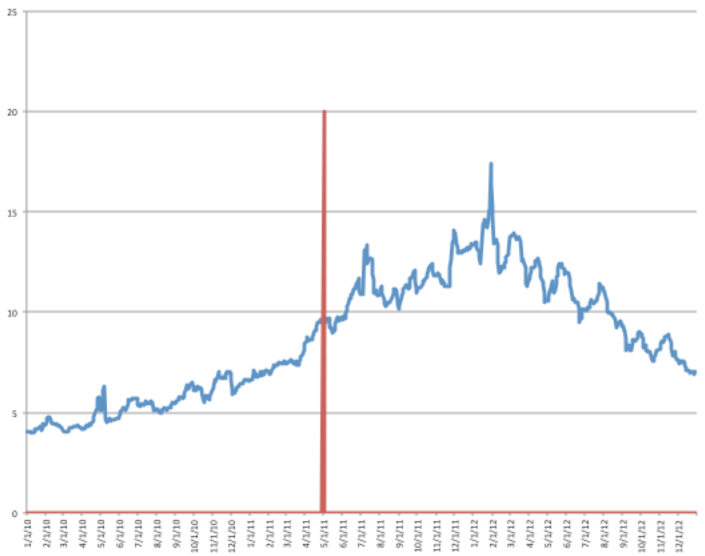

Figure 1

paramount importance. The influence of the central bank can also operate through other channels such as announcements that may signal its greater or lesser willingness to provide financial assistance to eurozone crisis countries facing acute liquidity shortages.

6. In the latter context it is possible to single out the three most important interventions of the ECB. First, the announcement on December 8, 2011 (that is, before the Portuguese yield reached its maximum) of the first Long Term Refinancing Operation (LTRO), through which the central bank made liquidity available to banks under more favorable conditions. Next, in February 2012, the ECB announced a further liquidity injection of the same LTRO type, but in a larger amount. Finally, the famous Mario Draghi phrase pronounced in July 2012 should be mentioned: "*I´ll do whatever it takes to save the euro.*".

7. The first LTRO liquidity injection amounted to 250 billion euros while the second one increased to 950 billion. Thus the two operations totalled 1.2 trillion euros. Figure 2 shows the distribution of this total among eurozone countries.

From this total Portugal received about 4%, corresponding to 50 billion euros, a share considered relatively small.[4]. Note that this type of intervention tends to favor a decline in the corresponding sovereign yields through a reduction in the premium risk. In the Portuguese case, however, and in contrast to what happened with Spain and Greece, the ten-year yield continued to rise after this first intervention until it reached its maximum by the end of January (see Figure 3). This reinforces the belief that the ECB interven-

[4]The Finantial Times (26 January 2012) mentioned this limited participation of Portugal in the first liquidity injection: "Portugal is also the only peripheral eurozone bond market that has failed to rally since the European Central Bank announced plans to offer three-year loans to the eurozone's banks on December 8, a move that averted a credit crunch", FT - Alphaville 26/1/2012.

Figure 2

tions might not be the sole factor behind the evolution of the sovereign yields. Other country-specific factors would have also presumably contributed to the evolution.

	10Y GOV BONDS Yield			
	ESPANHA	PORTUGAL	GRECIA	IRLANDA
8/12/11	5.814	12.951	34.712	
30/1/2012	5.042	17.393	34.032	

Figure 3

8. The third important ECB intervention during this period is the famous statement by Draghi "*I'll do whatever it takes*", made on July 26, 2012 and the accompanying declaration of the willingness of the central bank to conduct whatever liquidity injections OMT (Outright Monetary Transactions) might be necessary to give support to that statement. This important intervention was interpreted by the market as the willingness to provide unlimited support, if necessary, to countries facing acute liquidity crises that could endanger the monetary union itself. This would broadly correspond to the role of the ECB as a lender of last resort. The legal basis for such a bold move and its conformity with the statutes of the central bank were vigorously questioned in some quarters, but the European Court of Justice refrained from considering it out of its remit.

9. What effects, if any, followed from these interventions in the Portuguese yields? Figure 4 replicates Figure 1, adding vertical lines to indicate the dates of the two LTRO interventions and the Draghi statement.

One can see that the Portuguese yields started to fall from the January maximum only after the second LTRO. The central bank interventions certainly had contributed to this decline. Eichenbaum, Rebelo, and Resende, in a study conducted about the implementation of the *troika* program in Portugal, assert:

> *"Portuguese banks participated actively in both LTROs. Perhaps not coincidently, Portuguese yields and spreads vis-a-vis Germany*

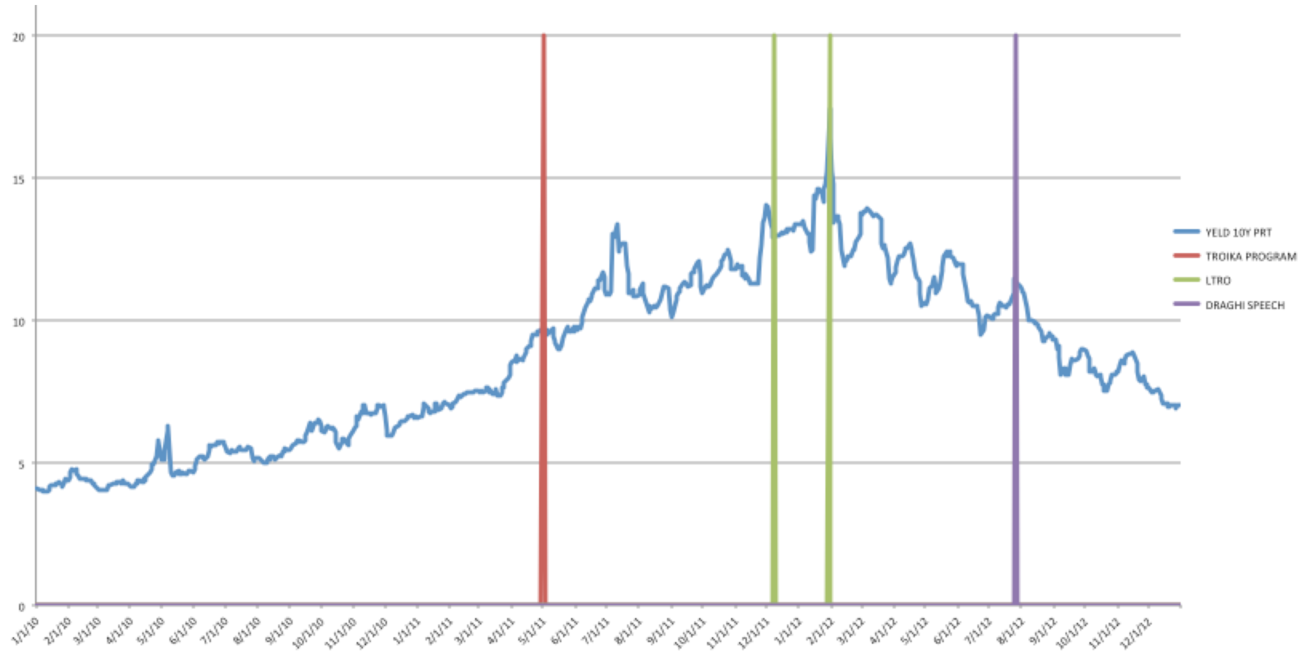

Figure 4

> *started to decline when the second LTRO was established. These facts suggest, but do not prove, that the LTRO programs played an important role in reducing the yield on Portuguese sovereign bonds and facilitating Portugal's return to international capital markets."*[5]

10. On the other hand, the Draghi speech and the accompanying announcement of OMT, which many consider to be the decisive factor in restoring eurozone market confidence, does not seem to have had a significant impact on the declining path of the Portuguese yield that had begun about six months earlier. This point is again commented on by Eichenbaum, Rebelo, and Resende:

> *"The evidence regarding the impact of the Draghi speech and the announcement of the outright monetary transactions program is more ambiguous. The decline in yields on Portuguese bonds began well before the Draghi speech, and seems to have stalled by June 2012, but it resumed after the Draghi speech in July."*

It is possible, of course, to speculate that the evolution of instability in the eurozone might have somehow contributed to a gradual build-up of the anticipation of some forthcoming drastic intervention on the part of the ECB to assure the ultimate survival of the monetary union. To use an expression common during that period of instability, the market might be expecting the central bank to use a "bazooka" or even an "atomic bomb". But if this expectational phenomenon did occur, its anticipation would have spread its

[5] "The Portuguese Crisis and the IMF", *IEO Background Paper*, BP 02-05-2016, p. 44 e ss.

beneficial stabilization effects across the whole eurozone, especially on the periphery, where instability was more acute. Does this correspond to what we observed in that special semester that preceded the Draghi speech?

11. Figure 5 adds the behavior of the ten-year yields of Spain and Italy, two periphery countries also afflicted by instability in the financial markets. The comparision with the Portuguese yield shows a sharp contrast. While the Portuguese rate shows a downward trend during this period, the Spanish and Italian yields show an increasing trend instead (especially after March, when a restructuring of the Greek debt, also indicated in the figure, took place) and they start to decline much later, only after the Draghi speech[6].

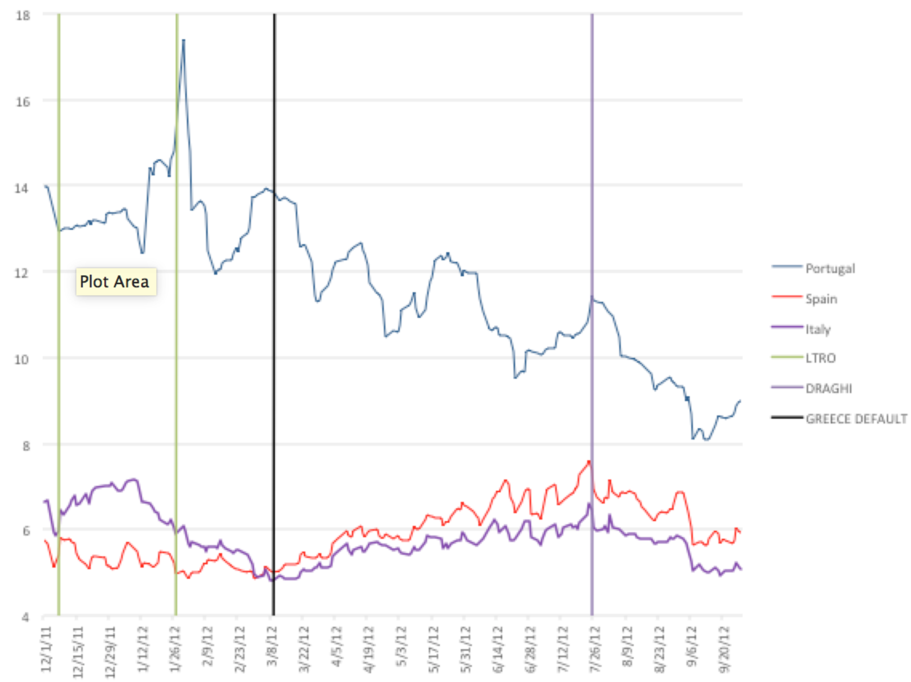

Figure 5

12. Could the observed decline in Portuguese yields reflect some possible influence of the country ratings regularly published by the main agencies? Did any rating upgrade occur during that period? If that happened, the improvement in market confidence as expressed by the reduction in yields may to some extent reflect the influence of such a piece of information. The only known rating modification in this period came from Standard & Poors, on January 13, and was a downgrading from the BBB- status (previously set, on December 5, 2011) to BB. If any effect were to be expected from this announcement, it would be an increase in the yield; and it indeed happened. The already rising yield experienced a further sharp increase, until it reached its maximum at the end of January as we noted above. Therefore, the increase in market confidence which we believe expressed itself afterwards (after January 31) occured despite

[6]It is sometimes speculated that had the instability not contaminated larger economies like Spain and Italy, the Draghi speech might not have been produced in the first place.

this earlier negative message conveyed by S&P. At the same time, it must be mentioned that the other two agencies, Fitch and Moodys, kept their previous ratings during this period, both of them at the below investment grade level.

13. An influence often suggested as an important explanation to the sovereign yield behavior is the role of banks, particularly the domestic ones. In the case of Portugal, the portuguese banks have increased their exposition to sovereign debt during the first semester of 2012. To what extent can this increase explain the downward trend in the 10-year yields observed during that period as compared with the spanish and italian ones? Note that the possible relevant role to that explanation of sovereign debt demand by banks is not incompatible, in principle, with our previous interpretation. In fact, it could similarly express a turn into a more optimistic view about the evolution of the portuguese economy by the banks. But since we cannot exclude the possibility that other factors might have also played a role, it seems useful to consider the information exhibited in the following table about the evolution of peripherial bank exposure to sovereign debt:

Sovereign Bond Holdings by OMFIs(million euros)

	Portugal	Italy	Spain
Dec 2011	22651	265408	186427
June 2012	30305	354286	225796

Source: Bruegel Data Set

In the first semester of 2012 we may note a significant increase of about 7.6 bn euros of portuguese banks exposure to portuguese sovereign debt, a 33.8% rise over the holdings at December 2011. At the same time, however, a concomitant rise occured with the italian (88.9 bn euros, representing 33.5%) and spanish debt (39.4 bn euros, representing 21%). It seems therefore difficult to explain the contrasting behaviour of yields based on this banking factor.

14. Only additional factors over and above common influences like the interventions of the ECB can explain the different behavior among the yields in the periphery countries. Those factors should express the impact of country specific circumstances. In the Portuguese case the most plausible interpretation, in our view, points to the conjecture that at a certain point the financial markets started to admit that the country's economic and financial difficulties were somehow beginning to come under control. In this interpretation the specific nature and quality of the policies implemented in the countries under adjustment might have been a relevant factor to explain the idiosyncratic behavior in yields. In this respect, the first semester of 2012 gave a rare opportunity to observe the discriminating behavior of an indicator—the ten-year sovereign yield—that is subject, at the same time, to strong common influences.

15. To conclude, the austerity package implemented in Portugal, besides the well-documented negative Keynesian effects, might have simultaneously provided an important and less often acknowledged ingredient to the recovery of the economy, namely an increase in the investors' confidence as expressed by a sustained decline in the yields in financial markets.[7] To that extent, it might be said that the program also included an expansionary component, in the sense that a sharper contraction of the economy would have likely occured had that element been absent. The possible coexistence of the two competing arguments about macro effects of austerity should therefore not be *a priori* excluded in macroeconomic reality. The first semester of 2012 seems to have provided a singular occasion to reinforce the belief in this possible coexistence in the Portuguese crisis experience.

Lisbon, September 12, 2018.

[7] Krugman, for example, does not recognize this point: "I see these moves (the decline in interest spreads against Germany for troubled countries) as indicators of the effects of ECB policies—the LTRO program at the end of 2011, and the signaled willingness to buy sovereign debt beginning last summer. But they see it as proof that the confidence fairy has arrived", Euro Delusions, 24/2/2013, P. Krugman, *The Conscience of a Liberal*.

Nova School of Business and Economics
Faculdade de Economia
Universidade Nova de Lisboa
Campus de Campolide
1099-032 Lisboa PORTUGAL
Tel.: +351 213 801 600

www.novasbe.pt